

Message Text

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S E C R E T SECTION 1 OF 3 SEOUL 1145

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MESSAGE 7 OF 8

EO 11652: GDS
TAGS:PFOR PINT KS US
SUBJ: US ECONOMIC POLICY TOWARD KOREA

SUMMARY: KOREAN ECONOMIC DEPENDENCE ON THE U.S. CONTINUES TO GROW. U.S. POLICY TO SUPPORT FREE TRADE HAS REPLACED AID IN IMPORTANCE TO THE KOREAN ECONOMY. OFFICIAL BALANCE OF PAYMENTS SUPPORT REMAINS IMPORTANT AND CONSTITUTES A CRITICAL SAFETY NET, PARTICULARLY GIVEN SECURITY CONSIDERATIONS. END SUMMARY

I. STATEMENT OF THE PROBLEM

A. ALTHOUGH THE U.S. STATE IN KOREA'S ECONOMY CONTINUES TO GROW, IT CANNOT BE MEASURED IN PURELY ECONOMIC TERMS. THAT INTEREST DERIVES, IN THE FINAL ANALYSIS, FROM ITS ASSOCIATION WITH OUR SECURITY INTERESTS, BOTH SPECIFIC TO KOREA AND REGIONAL. THUS, U.S. INTERESTS COMPEL US TO UNDERTAKE POLICIES BEYOND WHAT WE WOULD FOR OTHER COUNTRIES OF COMPARABLE SIZE AND DEVELOPMENT. THE POLICY VARIABLES WE HAVE TO WORK WITH INCLUDE BALANCE OF PAYMENTS SUPPORT, ACCESS TO THE U.S. AND WORLD MARKETS FOR KOREAN EXPORTS, FOR CAPITAL, AND FOR TECHNOLOGY, AND INFLUENCE ON KOREAN ECONOMIC POLICIES. THE ISSUE FACING THE U.S. IS THE APPROXIMATE MIX OF THESE VARIABLES.

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NOLOGY, AND INFLUENCE ON KOREAN ECONOMIC POLICIES. THE ISSUE FACING THE U.S. IS THE APPROXIMATE MIX OF THESE VARIABLES.

II. CONSIDERATIONS

A. SECURITY: THE SECURITY ASPECT OF OUR ECONOMIC

INTEREST MAY BE SEEN IN SEVERAL LIGHTS. KOREA'S RAPID RATE OF GROWTH HAS BEEN SUSTAINED BY A HIGH RATE OF INVESTMENT FINANCED PRINCIPALLY BY DOMESTIC SAVINGS, BUT ALSO BY A CRITICAL AMOUNT OF FOREIGN BORROWING. THAT GROWTH PERFORMANCE, IN TURN, HAS PROVIDED A GROWING SLICE OF THE GNP PIE FOR PRIVATE CONSUMPTION WHICH HAS MADE SUPPORTABLE THE GROWING SAVINGS AND TAX BURDEN TO PROVIDE ADDITIONAL INVESTMENT AND SECURITY EXPENDITURES. PUBLIC SUPPORT FOR A GROWING DEFENSE EFFORT HAS BEEN ENHANCED IN KOREA, AS IN THE U.S., AS THE BURDEN HAS NOT MEANT A REDUCTION FROM PREVIOUSLY ACHIEVED BUT STILL LOW LIVING STANDARDS.

B. SECURITY IS ENHANCED, TOO, IF THE ECONOMY IS PERCEIVED BY THE NORTH AS CARRYING A PROMISE THAT THE LONGER THE DEVELOPMENT PROCESS CONTINUES, THE LESS LIKELY IS ANY MILITARY EFFORT TO SUCCEED IN CONQUERING THE SOUTH. AT THE SAME TIME, THE REMNANTS OF U.S. MILITARY ASSISTANCE, GUARANTEED CREDITS, ARE EASIER TO JUSTIFY TO OUR PUBLIC IF THE KOREANS ARE MAKING A FULL EFFORT WHICH IS SEEN TO BE EFFECTIVE AND LONG LASTING AND WHICH IN FACT IS DIMINISHING THE U.S. BURDEN OVER TIME.

C. U.S. ECONOMIC INTERESTS: SIMULTANEOUSLY, PURELY ECONOMIC U.S. INTERESTS IN KOREA ARE GROWING RAPIDLY. IT HAS BECOME FOR US THE SECOND LARGEST MARKET IN ASIA (ALONG WITH TAIWAN) AND AN INCREASINGLY IMPORTANT SOURCE OF LABOR INTENSIVE PRODUCTS THAT WE COULD NOT PRODUCE OURSELVES ANYWHERE NEAR SO CHEAPLY,
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EXCEPT WITH UNACCEPTABLY LOW WAGE SCALES. KOREA, MOREOVER, HAS ALREADY ADVANCED BEYOND THE LOWEST-WAGE TEXTILE AND APPAREL PRODUCTS AND IS DIVERSIFYING INTO ELECTRONICS, MACHINERY, SHIPBUILDING AND OVERSEAS CONSTRUCTION, THUS, IT MAY BE EXPECTED IN FUTURE YEARS TO BECOME A SOURCE OF INCREASINGLY DIVERSE EXPORTS TO MORE AND MORE COUNTRIES. AS SUCH, IT SHOULD ACHIEVE GROWING IMPACT ON THE WORLD ECONOMY, EVEN AS THE U.S. DIRECT STAKE GROWS.

D. U.S. FINANCIAL STAKE: U.S. ECONOMIC INTERESTS ALSO TAKE THE FORM OF DIRECT INVESTMENT, THOUGH THE BOOK VALUE MEASURED AT THE TIME OF COMMITMENT SEEMS SMALL (SEVERAL HUNDRED MILLION DOLLARS) AND IS ONLY HALF OF JAPANESE DIRECT INVESTMENT. THE U.S. NUMBERS, HOWEVER, ARE DECEPTIVE IN THAT THEY IGNORE THE CONTINGENT LIABILITY OF MANY INVESTORS FOR LOANS MADE TO THEIR KOREAN SUBSIDIARIES, MOSTLY JOINT VENTURES. IN ADDITION, THE U.S. BANKING SYSTEM HAS AN EXPOSURE

OF SEVERAL BILLION; WHILE MUCH OF IT IS SHORT TERM,
AND PRESUMABLY COULD BE LIQUIDATED QUICKLY, ASSURANCE
OF THIS DEPENDS ON ROKG UNWILLINGNESS TO DEFAULT WHEN
THERE IS A RUN ON ITS EXCHANGE RESERVES.

E. RISK OF DEFAULT: U.S. PRIVATE SECTOR LOANS
AND INVESTMENTS ARE ONLY PARTLY GUARANTEED BY THE USG.
YET ULTIMATELY THEY WERE MADE IN ANTICIPATION OF USG
RECOGNITION OF ITS ECONOMIC AND SECURITY INTERESTS
IN KOREA. A CHANGE IN CREDITORS' PERCEPTIONS OF USG

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THINKING WOULD THEN HAVE AN IMMEDIATE NEGATIVE IMPACT
ON THEIR WILLINGNESS TO MAKE NEW DEALS, WHICH HAVE
THE EFFECT OF ROLLING OVER THE ROK CENTRAL BANK'S
EXCHANGE OBLIGATIONS. A CHANGE IN U.S. CREDITORS'
PERCEPTION OF THE RISKS COULD NOT, OF COURSE, BE
KEPT FROM OTHER NATIONS, AND WILL PRECIPITATE A GENERAL
CREDITOR PANIC AND ROKG DEFAULT.

F. SECURITY IS KEY: THE ULTIMATE ECONOMIC POLICY
QUESTION FOR U.S.-KOREA RELATIONS IS THE MAINTEN-
ANCE OF CONFIDENCE IN KOREAN SECURITY. GROUND TROOP
REDUCTION, EVEN IF HANDLED WITH APPROPRIATE PUBLIC
DISCUSSION AND UNDERSTANDING, WOULD CREATE DOUBTS.
FOLLOWED BY OTHER ACTS WHICH TENDED TO SUPPORT THE
CONCLUSION THE USG WAS CUTTING ITS COMMITMENT, WHAT
STARTED AS EROSION OF CONFIDENCE COULD PRODUCE A
PERMANENT AND RAPID CHANGE.

G. OTHER KOREAN NEEDS: ALTHOUGH A PAUSE IN KOREA'S ECONOMIC GROWTH, NO MATTER WHAT THE CAUSE, COULD HAVE BROAD CONSEQUENCES, THE RECESSION OF 1974-75 DID NOT HAVE SUCH EFFECTS. HOWEVER, THE ROKG HAD TO WORK VERY HARD TO KEEP THE ECONOMY MOVING. THE DECEMBER 1974

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DEVALUATION, PUBLIC WORKS SPENDING, AND HEAVY FOREIGN BORROWING GOT KOREA THROUGH WHAT WAS FOR MOST OTHER COUNTRIES DISASTROUS YEARS, WITH 8.5 PERCENT REAL GNP GROWTH, BUT INFLATION ALSO RAN 25 PERCENT ANNUALLY, AND THE COUNTRY ENDED OWING \$4 BILLION ADDITIONAL ABROAD, MORE THAN DOUBLE ITS PREVIOUS FOREIGN INDEBTEDNESS. CRUCIAL IN THIS BORROWING WAS A MODICUM OF OFFICIAL CREDITS OR GUARANTEES WHICH HAVE HAD THE EFFECT OF LENGTHENING THE TERM OF KOREA'S DEBT (BANK LENDING IS NEVER AVAILABLE FOR MORE THAN SEVEN YEARS, AND IN PRACTICE, THE LIMIT IN KOREA IS FIVE). EQUALLY IMPORTANT, THE ABSENCE OF USG CREDITS AT SUCH A TIME WOULD HAVE PERSUADED THE PRIVATE SECTOR THAT THE RISKS WERE TOO GREAT. THE AVAILABILITY OF SUCH CREDITS WILL UNDOUBTEDLY PROVE CRITICAL AGAIN, IF THE KOREAN ECONOMY FINDS ITSELF IN SERIOUS DIFFICULTY.

H. NECESSITY FOR CONTINUED GROWTH: THE KOREAN ECONOMY IS WELL MANAGED AND SOUND, JUDGING FROM ITS TRACK RECORD TO DATE. HOWEVER, IT IS VULNERABLE TO LACK OF CONTINUED PROGRESS, PRODUCING NEGATIVE SECURITY, WELFARE, AND POLITICAL CONSEQUENCES. CONTINUED GROWTH IS CRUCIAL TO POLITICAL STABILITY AND PARK'S CONTINUATION IN POWER. THUS, WHILE WE DO NOT EXPECT THE ECONOMY TO FALTER, IT COULD DO SO AS A CONSEQUENCE OF LACK OF GROWTH OF INDUSTRIAL EXPORTS, THE LEADING SECTOR OF THE KOREAN ECONOMY. SOFTNESS IN DEMAND FOR KOREAN EXPORTS IN THE U.S. AND JAPAN WOULD BE VERY SERIOUS, AS WOULD GROWTH OF PROTECTIONISM SUFFICIENT TO CUT OFF KOREA'S GROWTH.

I. FAVORABLE INTERNATIONAL ENVIRONMENT: A WORLD ECONOMIC SYSTEM SERVING KOREA'S NEEDS FOR MARKETS AND CAPITAL, NOT TO MENTION TECHNOLOGY, AND INCLUDING EVENTUAL MEMBERSHIP IN THE OECD, THUS BECOMES A SINE QUA NON FOR THE ECONOMY'S SURVIVAL,

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AT LEAST IN THE PRESENT FORM, THE PROMISE OF SUCH A

SYSTEM, AS WELL AS KOREAN EXPERIENCE WITH IT, HAS
VALIDATED KOREAN POLICY TO FOLLOW AN EXPORT-LED
DEVELOPMENT STRATEGY, AND TO USE CONSIDERATIONS OF
COMPARATIVE ADVANTAGE INCREASINGLY TO DETERMINE ITS
INVESTMENT AND OTHER ECONOMIC POLICIES.

J. DOMESTIC POLICY: THESE WORLD ECONOMIC
CONSIDERATIONS, AS WELL AS KOREA'S RECOVERY FROM
THE 1974-75 RECESSION, HAVE LED US DURING THE LAST
NINE MONTHS TO ARGUE STRONGLY WITH KOREAN POLICY
MAKERS THAT THEY WERE THEMSELVES IN DANGER OF
CARRYING LOCALIZATION AND NON-TARIFF PROTECTION
TOO FAR. IF CONTINUED, IT WOULD LIKELY CREATE
SERIOUS INVESTMENT ERRORS, WHICH WOULD MAKE A LARGE
PART OF THE ECONOMY UNCOMPETITIVE IN WORLD MARKETS
AND RESULT IN A SERIOUS WELFARE COST FOR THE KOREAN
CONSUMER, AS WELL AS WEAKENING THEIR DEFENSE.
FORTUNATELY, KOREAN ECONOMISTS AND PLANNERS WERE
ALREADY FULLY AWARE OF THE DANGERS. THEY HAVE
TAKEN U.S. CONCERNS AS HELPFUL IN GOVERNMENT POLICY
DISCUSSIONS. THEY ALSO REALIZED THAT KOREAN
FAILURE TO LIBERALIZE ITS IMPORT SYSTEM MIGHT PRODUCE
RETALIATION, AND CERTAINLY MADE IT MORE DIFFICULT
FOR KOREA'S ALLIES ON TRADE ISSUES TO OPPOSE PROTECTION-
IST MEASURES DESIGNED TO KEEP KOREAN GOODS OUT.

III. OPTIONS

A. THE OPTIONS DISCUSSED HERE DO NOT COMPRISE A
SET OF ALTERNATIVES AS WITH THE CONVENTIONAL PRESENTA-
TION OF OPTIONS. RATHER, THE CHOICE FOR THE U.S.
IS TO WORK OUT A MIX WHICH ACHIEVES OUR ECONOMIC AND
RELATED OBJECTIVES.

B. BALANCE OF PAYMENTS SUPPORT: WHILE THE NEED
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FOR CONCESSIONAL AID HAS GONE, KOREA PLANS TO CONTINUE

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TO BORROW ABOUT \$2 BILLION A YEAR OVER THE NEXT FIVE YEARS. THOUGH ABOUT \$1.2 BILLION A YEAR WILL BE OFFSET BY REPAYMENT OF PRIOR LOANS, THE GROSS LEVEL IS HIGH, AND COULD GO HIGHER IF SECURITY COSTS RISE. WE NOW ESTIMATE THAT KOREA CAN RAISE THESE FUNDS, PAYING COMMERCIAL RATES, BUT NEEDS TO GET A GOOD PORTION ON LONGER-TAN-COMMERCIALLY-AVAILABLE MATURITIES FROM THE U.S. AND JAPANESE EXPORT IMPORT BANKS, THE WORLD BANK AND THE ADB. IF WORLD ECONOMIC CONDITIONS DETERIORATE OR KOREA'S MILITARY BURDEN GROWS, HOWEVER, THE QUESTION OF ADDITIONAL USG FINANCING WILL BE POSED. SIMILARY, A LOSS OF CONFIDENCE IN THE SECURITY SITUATION WOULD MAKE USG GUARANTEES OR SUBSTITUTE FINANCING CRITICAL TO KOREA'S CONTINUED ACHIEVEMENT OF ITS TARGETS. POLITICAL-SECURITY CONSIDERATIONS MAY JUSTIFY BALANCE OF PAYMENTS SUPPORT BEYOND WHAT IS ECONOMICALLY JUSTIFIED: A FIVE-YEAR COMMITMENT TO A GIVEN LEVEL OF SUPPORT WOULD BE MOST USEFUL IN THIS RESPECT.

C. ACCESS TO U.S. MARKETS: KOREA EXPORTS

ABOUT A THIRD OF ITS TOTAL TO THE U.S. THOSE EXPORTS HAVE BEEN NEEDED IN ORDER TO PAY FOR ITS IMPORTS OF RAW MATERIALS AND INVESTMENT GOOD AND TO SERVICE ITS
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FOREIGN INDEBTEDNESS. U.S. AS WELL AS THIRD COUNTRY PROTECTIONIST MEASURES (AND INCIDENTALLY FISHING LIMITS) HAVE RAISED THE QUESTION OF WHETHER KOREA CAN CONTINUE TO PURSUE ITS PRESENT COURSE. THE COUNTRY'S PLANNERS, WITH U.S. SUPPORT, HAD PREVIOUSLY RESPONDED BY A SEARCH FOR NEW EXPORT PRODUCTS, WHICH WERE ALREADY REQUIRED IN ANY CASE IN ORDER TO RAISE LIVING STANDARDS BY FINDING HIGHER WAGE OCCUPATIONS. THE U.S. COMMITMENT TO A WORLD ECONOMIC SYSTEM, CO-OPTING THE DEVELOPING COUNTRIES, COORDINATING DOMESTIC ECONOMIC POLICIES, AND PROGRESSIVELY FREEING

TRADE, PARTICULARLY FROM NON-TARIFF LIMITATIONS, IS OF GREAT LONG-RUN HELP TO KOREA. IN THE SHORT-RUN OF THE NEXT FEW YEARS, HOWEVER, THE POSSIBILITY OF A SIGNIFICANT LOSS OF MARKETS, IN BOTH THE U.S. AND THE OTHER DEVELOPED COUNTRIES, BECAUSE OF ATTEMPTS TO LIMIT FOREIGN COMPETITION, IS VERY REAL IN KOREAN MINDS. USG SUCCESS IN FORESTALLING SUCH MEASURES WILL THUS BE VERY IMPORTANT TO KOREAN DEVELOPMENT. ALTERNATIVELY, THE U.S. CAN OFFSET SOME OF THE IMPACT OF LOST EXPORTS BY PERMITTING KOREA TO BORROW ABROAD AND MAINTAIN ITS GROWTH, AS IT DID IN THE RECESSION OF 1974 AND 1975. THE KOREAN EYES, LIBERAL U.S. AND WORLD TRADE POLICIES HAVE A LONG-TERM ASSURANCE, THAT RENEWED USG BALANCE OF PAYMENTS SUPPORT LACKS, PARTICULARLY IF GIVEN ON A YEAR-TO-YEAR BASIS. TRADE IS BETTER THAN AID, BUT FAILING TRADE, THE ROKG WILL TAKE AID.

D. KOREAN DOMESTIC ECONOMIC POLICY: THE U.S. HAS OVER THE YEARS BEEN ABLE TO INFLUENCE ROKG ECONOMIC POLICY, ALONG WITH THE WORLD BANK AND IMF, AS IT BECAME PERSUADED THAT ITS DEVELOPMENT HAS BEEN SUCCESSFUL WITH THIS HELP AND ADVICE. ANY U.S. TROOP REDUCTION OR ECONOMIC SETBACK COULD BE OFFSET, IN THEORY, BY REDUCING CONSUMPTION OR INVESTMENT. THOSE ARE NOT VALID ALTERNATIVES OVER THE LONG PULL,

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SO THAT THE KOREANS ARE SEEKING GREATER EFFICIENCY AND COMPETITIVENESS TO THOSE ENDS, AND THUS IN ORDER TO MAXIMIZE NATIONAL WELFARE, CURRENT U.S. POLICY IS TO ENCOURAGE LIBERALIZATION OF IMPORTS. HOWEVER, TO ARGUE FOR FREE TRADE IN A PROTECTIONIST WORLD IS LIKELY TO FAIL. THE U.S. COMMITMENT TO FREE TRADE, EVEN THOUGH THERE MAY BE TEMPORARY EXCEPTIONS IN PARTICULARLY SEVERELY AFFECTED PRODUCTS, IS THUS VERY HELPFUL TO THOSE KOREANS PUSHING LIBERAL TRADE POLICIES, AS WILL U.S. LEADERSHIP OF KOREA'S OTHER LARGE TRADING PARTNERS ALONG THE SAME LINES. ON THE OTHER HAND, PROTECTIONISM IS LIKELY TO PRODUCE A NEW, INWARD LOOKING, AUTARKIC DIRECTED LINE, WHICH WILL EITHER COST THE COUNTRY GROWTH OR REQUIRE ADDITIONAL EXTERNAL HELP.

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